Pakorn Malakul na Ayudhya: Central bank independence - what does it mean? The Bank of Thailand's experience

Remarks by Mr Pakorn Malakul na Ayudhya, Deputy Governor of the Bank of Thailand, on the occasion of The Inauguration of the Monetary Policy Committee, Bank of Ghana, Accra, 10 September 2002.

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Mr. Chairman, Governors, Members of the MPC, Distinguished guests, Ladies and Gentlemen,

I consider it a great honour to be invited by the Bank of Ghana to take part in this very important event, the inauguration of the MPC. I would also like to thank Governor Paul Acquah and the Bank of Ghana for the warm hospitality extended to me and my staffs. It has certainly made our first visit to Ghana a very memorable one.

Before I begin my talk on the assigned topic of **Central Bank Independence: What Does It Mean? The Bank of Thailand's Experience**, I would like to offer my congratulations. The first one is for Governor Paul Acquah and the Bank of Ghana for the successful launching of the MPC. The ceremony which took place yesterday was very impressive. The message came across very clearly that the Government places great importance upon the Bank of Ghana's independence and that much reliance is placed on the MPC for its successful conduct of monetary policy so that price stability and consequently sustainable growth can be achieved. The exact words used by your Finance Minister were essential pillar for macroeconomic stability. My second congratulation is also for Governor Paul Acquah for having achieved the Central Bank independence. I have noted that the Bank of Ghana was established in 1957. The Bank of Thailand was established in 1942 and we have not managed to gain independence through legal means yet. So, you are one up on us.

Ladies and Gentlemen, the issue of "Central Bank Independence and Monetary Policy" is very much closed to the heart of all central bankers, and I am very happy to be able to share some thoughts on it. In Thailand's case this issue has been much discussed among all concerned throughout the 60 years period since the Bank of Thailand's establishment in 1942.

One of the most famous governors of the Bank of Thailand and certainly the longest serving Governor (more than 10 years) had this to say about central bank independence and I quote

"…If the policy in question is so profound that it might undermine principles or lead to catastrophe, the Central Bank Governor may not only voice his disapproval against it, but he also has the ultimate prerogative of resigning from the governorship".

Dr. Puey Ungphakorn was an outstanding Governor who gave great importance to the Bank of Thailand to carry out its functions as an independent institution free from political and governmental domination, undaunted by any influential powers-that-be. For the sake of his country-and using the delicate art of being a central banker, Dr. Puey protested against the government whenever it did not act righteously.

Dr. Puey believed that the government must have faith in the central bank in providing benefits for the country as a whole. The Governor and senior management should have enough courage to voice their critical, even dissenting opinion when such an action is necessary. His view was that the Governor and his senior management cannot be saints, but must carry out their work adhering to the principles of honesty and integrity. Neither can they act indifferently, because when it is necessary to reprimand the government, they must do so.

Dr. Puey was determined to protect its officials from political interference. He issued regulations prohibiting Bank of Thailand officials to stand for political office or write articles on politics, which are still in force today.

I totally agree with what Dr. Puey had thus said and practiced without fail. However, since Governor Puey left the office at his own will to concentrate on another job which he loved dearly, that is, rector of Thammasart University, we have had nine governors over a period of almost 30 years. Out of this nine, only two retired from the office, the other seven were either fired or pressured to leave the post by the Government for some reason or another and in most cases the causes of removal had nothing to do with their performance in conducting monetary policy.

How could this have happened? The answer lies in the current Bank of Thailand Act which does not spell out or lay down mechanism for the central bank to achieve its independence. Governor and Deputy Governor are political appointees. They are appointed by His Majesty the King upon the recommendation of the Minister of Finance and approved by the Cabinet. There is no definite term of office. There are no protective clauses in the Act which clearly spell out causes for removal. The most popular reason given by the government when firing governors was one of “suitability”. None of the nine governors had the chance to resign from the office in protest of the Government policies as advocated by Dr. Puey. In the past 7 years, we have 5 Governors including the present one who has been in office for just over 1 year. However, it is important to note as well that sometimes the relationship between Minister of Finance and Governor of a Central Bank turned sour not because of policy conflict but because of personality mismatch that led to eventual conflict. For instance, the current Minister of Finance and the present Governor work well together and have great respect for each other.

What then is the solution? I think the best solution is to legalize Central Bank independence by spelling out clearly in the Central Bank legislation the power, duties, responsibility and accountability of a Central Bank. According to the draft amendment of the Bank of Thailand Act which is to be considered by the Parliament in the near future, some such important features are:

1. a Selection Committee, comprising some outstanding Thai senior statesmen, to nominate appropriate candidates for governorship.
2. a definite term of office for governorship (4-5 years is the norm and this can be extended for another term).
3. clauses which spell out clearly causes for removal of governor.
4. a Court of Directors which comprises of the Governor and Deputy Governors and at least five other members to oversee/manage/entrust the overall affairs of the Bank of Thailand. Question remains whether Governor should be chairman and CEO as well. There are pros and cons on this issue.
5. a Monetary Policy Board chaired by the Governor and consists of internal and external directors. External directors will be appointed by the Government. Responsibility and accountability of the board will be spelled out clearly. It is important to have qualified external directors to provide wider perspective and perhaps a counter balance views.

Since the draft Amendment of the Bank of Thailand Act will take time to be enacted because of a long legal and parliamentary processes (we expect it to be enacted in the middle of next year), we have decided to go ahead with the establishment of a Monetary Policy Committee (MPC). The MPC consists of seven members with the Governor chairing the committee. There are two external advisors who serve on the committee, providing independent thoughts and perspectives. The committee meets every six weeks on a pre-announced schedule. The main responsibilities of MPC comprises of:

- setting the direction of the monetary policy with the objective of maintaining price stability,
- examining and approving the monetary conditions and policy stance report, and,
- overseeing the quarterly Inflation Report.

Why did we adopt and implement inflation targeting as our new policy anchor?

As the fixed exchange rate was abandoned after the crisis, it was then necessary to have a new nominal anchor. At first the Bank of Thailand used monetary aggregates as its policy target under the IMF program. The Bank targeted domestic money supply in order to ensure macroeconomic consistency in order to obtain price stability. However, as in many countries in recent years, using money supply as a target did not work well with the Thai economy as the relationship between monetary aggregates and output became increasingly unstable. This was due to changes in people's spending behavior and the popularity of new money-related innovations, such as credit cards and electronic cash cards.

After studies and experimental implementation, the Bank of Thailand formally adopted the inflation-targeting regime starting from May 2000. The new nominal anchor allows the Bank of Thailand to set an explicit target of core inflation in order to stabilize price condition. Since its adoption, a target of core inflation had been set at a range of 0-3.5 percent and remains so. In addition, we have adopted 14-day repurchase rate as the policy instrument as well as employed macro econometric model to conduct the forecast.

Permit me to elaborate on some of the above mentioned issues with regard to the implementation of inflation targeting framework. The appropriate price index used was consumer price index (CPI) which should be excluding some items that cannot be influenced by monetary policy while still able to retain sufficient price information. Hence we used the core inflation which excludes volatile items of raw food and oil prices. This core inflation has less variation but from historical data, on average, it had been close to the headline inflation in the long run. We can say that targeting the core inflation is effectively the control of long-run inflation such that monetary policy does not have to accommodate supply shocks. In light of this, the target range of 0-3.5 percent was set based on Thailand and our major trading partners' history of inflation.

As for the choice of policy rate, the 14-day repurchase rate was selected as the key instrument. With this instrument, the Bank of Thailand is able to manage the appropriate level of liquidity in the market. The advantage of 14-day repurchase rate over other rates of longer maturities is that the trading volume is much higher and thus provides effective policy signaling to the market. It also has advantage over the rate of shorter maturities, such as 1-day or 7-day, in that it will not impose too much burden on the Bank of Thailand in taking care of the liquidity and maintaining the policy rate. Therefore, other repurchase rates such as 1-day or 7-day will be freely determined by market forces. In sum, the 14-day RP rate will leave room for the short-term rate with flexibility to adjust and move in line with money market liquidity conditions.

The policy rate was initially set at 1.5 percent per annum and it was raised to 2.5 percent in June 2001 to realign the money market interest rates. Following the global economic slowdown, the policy rate had been cut twice in December 2001 and January 2002 to help stimulate the economy. The rate now stands at 2 percent per annum.

Having the policy rate clearly announced, the Bank of Thailand is able to provide a transparent monetary policy signal to the market. This helps provide a framework for a more effective transmission mechanism. After the adjustment in the policy rate, other rates in the repurchase market will adjust in line with the policy rate. Banks will thereafter adjust their portfolio and change their rates for loans and deposits. The transmission mechanism will work itself out such that this will eventually lead to the desirable result in the real sector. The policy impact usually takes up to 8 quarters in the transmission process. Nevertheless, in the case of Thailand after the crisis, the banking system has not yet been fully functioned and this, to a certain extent, undermined the effectiveness of the monetary policy.

The macro-model gives a range of core inflations with probability distribution being described into a fanchart. This fanchart takes into account the related uncertainties and gives some flexibility in a range of forecasts. Based on the most likely outcome, the MPC will announce the expected rate of inflation for this year and next year. According to the most recent assessment, the core inflation will be 0.5-1 percent in 2002 and 0.5-1.5 percent in 2003, providing growth of between 3-4 percent in 2002 and 2003.

Finally to enhance transparency of the process, Inflation Report is published on the quarterly basis providing forecasts of inflation and economic growth for the next eight quarters along with the quarterly press release.

For the final part of my talk, I would like to dwell on the issues of **Central Bank Independence**. The first issue is whether a Central Bank can have too much independence in the sense that it can be harmful. To this, I incline to say yes, but only in a rare circumstance. Bad decisions relating to monetary or financial institutions operations can be damaging with wide impact. To prevent this from happening, a mechanism should be installed such as a Monetary Policy Committee or a Financial Institutions Policy Committee comprising of qualified external directors so that important policy measures are made through group decisions.

The **second** issue is how independence should a Central Bank be? I believe that a Central Bank should be independent within the government because it is the Minister of Finance who has to be accountable to the parliament on issues relating to macro economic, fiscal, monetary and financial system matters. I agree absolutely with Governor Paul Acquah that monetary and fiscal policies must be harmonized in order to achieve macro stability, meaning that a Minister of Finance and a Governor of a Central Bank must work hand in hand to achieve a proper policy mix of fiscal and monetary policies so that sustainable growth can be achieved.

Ladies and gentlemen, I feel that I have taken enough of your time already. Therefore, I would like to conclude that a Central Bank can be considered as having its independence when it can perform its duty of achieving and maintaining price stability without any political or governmental interference, and with honesty and integrity while working hand in hand with the Ministry of Finance to achieve a balanced fiscal and monetary policies mix that lead to macro stability and sustainable growth. Inflation targeting approach is an effective mean to achieve Central Bank independence because it encompasses 4 very important ingredients: operational independence, responsibility, transparency and accountability. Other means can be just as effective if they have these 4 required ingredients.

I hope that what I have just shared with you on the topic of Central Bank Independence and our experiences in adopting inflation targeting as a nominal anchor will be of some uses as food for thoughts. Finally, I truly wish to congratulate the Bank of Ghana for the successful launching of Monetary Policy Committee.

Thank you.